Impact investing in private equity – a UK pension fund perspective

Impact Lens
Pensions for Purpose

Sponsored by
Columbia Threadneedle Investments

Contents

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Executive summary

Executive summary

Impact investing in private equity – a UK pension fund perspective

Pensions for Purpose's latest research paper, sponsored by *Columbia Threadneedle Investments* explores how the UK pension fund market is viewing impact in private equity.

Columbia Threadneedle Investments is a global asset management firm providing investment solutions in private equity. They invest mainly in mid-market buyouts through funds (primaries and secondaries) as well as co-investments. Their belief is that independent research allows information to be turned into forward-looking insights, resulting in smarter investment decisions. To collect the data for the report, *Pensions for Purpose* surveyed a range of pension funds and investment consultants. A summary is below.

1 HOW DO PENSION FUNDS VIEW IMPACT?

1. Why do they invest for impact?

Many of the pension schemes intentionally investing for impact have taken the view that impact investing has material financial benefits, not just for a specific investment but also to their whole portfolio, through the reduction of systemic risk. For defined contribution (DC) schemes, there is the added benefit of improved member engagement while for local government pension schemes (LGPS), the levelling-up agenda has sparked interest in place-based impact investing.

2. Which impact themes do they target?

Most pension funds are not targeting specific impacts. Typically, they allocate to impact investments on a case-by-case basis. Despite this, the financial materiality of any environmental, social and governance (ESG) factor is the main consideration which comes into play. In the case of the LGPS, issues that matter to local stakeholders are also considered. It was noted that impact data can be difficult to obtain from private equity managers.

3. Do they have separate allocations to impact investments?

Of the funds asked, 42% have a separate allocation to impact. However, this is not necessarily the best way to achieve impact, funds which have higher weightings to impact investment do not have impact allocations.

4. What are their ESG engagement priorities?

Climate is the main engagement priority for pension funds but there are growing concerns around biodiversity, with some funds mentioning their aim of deforestation-free portfolios. On the social side, employment standards are a key area for engagement.

5. What are the biggest ESG risks/opportunities?

Climate is seen as the number one consideration, with the carbon market perceived by one fund as both the biggest risk and the biggest opportunity. The development of carbon and biodiversity credits will also help to price externalities more accurately, which would be positive for continued growth in the ESG and impact movement. Other opportunities existing within climate were mentioned, such as renewable energy, which has pertinence given high energy prices. The social side also provides many opportunities, particularly when looking through a global lens. Rising inequality is a systemic risk facing the world, though, and investors should address this by applying a just transition lens to their ESG activities. Within the 'G', private equity provides an opportunity for impact and for risk and return, because larger stakes allow for greater influence over the investee company.

6. Are they measuring the net-zero alignment of their portfolios?

Fifty per cent of pension funds are currently reporting the net-zero alignment of their portfolio. Data quality and coverage is an issue, however.

2 HOW DO PENSION FUNDS VIEW PRIVATE EQUITY?

1. What are their allocations to private equity investments?

For the vast majority, allocations to private equity are in the single figures. Many schemes are de-risking, so, for them, increases to their allocations are unlikely. But, due to the attractiveness of the asset class financially and in terms of impact, demand is there.

2. How interested are they in co-investments or secondaries?

In general, co-investments were seen as resource-intensive and, for the smaller LGPS, the governance burden was too heavy for them to consider investing. As a result, co-investing alongside a fund manager was seen as a good solution. For DC schemes, there were considerable upsides to co-investments – lower fees open doors to opportunities otherwise inaccessible due to cost caps imposed upon the pension fund. From a stewardship perspective, investing in secondaries may make it more difficult to engage but this was not seen as an issue with impact investment funds. It was also noted that secondaries have diversification benefits.

3. How important are liquidity and time horizons?

Although liquidity may be an issue for defined benefit (DB) schemes close to buyout, the LGPS and DC pension funds we spoke to did not regard liquidity as an issue. The LGPS see themselves as well-placed to benefit from illiquidity premiums and the DC schemes we interviewed have issues elsewhere, namely fee limitations. Time horizons for assessing returns and impact were around five years after capital deployment.

3 HOW DO PENSION FUNDS VIEW IMPACT IN PRIVATE EQUITY?

1. Why is private equity a well-placed asset class for impact?

Most pension funds and their advisers see private equity as the best way to achieve impact. Many reasons were outlined for this: they can support innovation; there is a broader universe of ideas; general partners (GPs) have greater influence over the company than public equity fund managers (due to greater stakes in investee companies); and the return profile is good.

2. How important is 'additionality'?

The investment consultants we spoke to pointed to a lack of client understanding of additionality. There is also the question of how investors can evidence additionality. Consequently, most pension funds do not seek additionality but clear and measurable impact. In our sample, the exception is one of the larger LGPS that has place-based impact goals and is acting as a catalyst for local economic growth by engaging asset managers to set up funds which invest in their local area, thereby encouraging neighbouring LGPS to invest. It was also mentioned that additionality could drive returns by identifying opportunities underserved by the market.

3. What percentage of them are invested in impact private equity?

Of the funds interviewed, 43% are invested in impact private equity.

4. Are they looking at single-focus or diversified products?

Some pension funds are keen to focus on single strategy products and move away from diversified ones. Others see the benefits of diversified strategies, particularly if their private equity allocation is small.

5. What are their geographical preferences for impact?

Traditionally, the location of pension funds' impact has been global but the trend is for UK pension funds to have a more domestic focus. This is largely driven by the LGPS and the government's levelling-up agenda, but also comes from DC funds which see UK impact as having high potential for member engagement. Impact ambitions tend to vary across impact themes. The focus of social impact is mainly within the UK, whereas climate impact tends to be more globally oriented.

6. What are their crucial criteria for impact private equity funds?

Track record and risk-adjusted return profile are central to assessing impact private equity funds. However, potential tension between past performance and emerging strategies was noted, particularly in the impact space, so a balance must be struck. Of those asked, 67% assessed the impact narrative before financial and practical considerations. This should be regarded comparatively, to assess where a pension fund can have the most impact. For DC schemes, fees often make impact private equity funds difficult to invest in, albeit the schemes we spoke to are trying to work around this.

4 HOW DO PENSION FUNDS VIEW IMPACT PRIVATE EQUITY RETURNS?

1. What are their return expectations from private equity?

The mean return expectation from private equity reported by the schemes questioned was 15%.

2.What does the academic literature on impact vs generalist fund returns say?

Academic research on the returns of impact funds versus generalist funds is limited and more work needs to be carried out. Methodological limitations and the infancy of the industry hinder the reliability of current research. Therefore, it is difficult to definitively answer whether impact funds produce higher returns than generalist funds. However, the research shows there are a number of opportunities for alpha in impact investing.

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Introduction

Introduction

Why did we conduct this research?

A lot of the noise in the impact investing industry has centred around private markets and most of the capital allocated to impact investing is in that space. Private equity, in particular, has received a lot of attention, as the characteristics of the asset class align well with the goals of impact investing.

The aim of this research project was to explore the perspective of UK pension funds on private equity impact investing, engaging the industry's views on questions such as why the asset class is particularly suited to impact investment, which impact themes are important to them and where geographically they want that impact to take place.

The following sections lay out the views of 17 pension funds – with a focus on LGPS and DC master trusts – and five investment consultants. It is important to note not every question was asked to every interviewee, so the sample size of any quantitative data may vary.

1 How do pension funds view impact?

How do pension funds view impact?

1. Why do they invest for impact?

Of the pension funds interviewed, 88% hold impact investments in some form or another. There was varied rationale among the participants for this but it is clear that a lot of pension funds see a financial gain to be made from impact investing. One fund believes climate risk is materially underpriced by the market and some more progressive DC and LGPS funds view impact investing as the future.

> "We're big believers that eventually this will just be the way that everyone invests."
> PENSION FUND

There was also a recognition of the role pension funds can play in securing a better world for everyone through the allocation of their capital. This approach will, in turn, reflect better on whole portfolios through the reduction of systemic risk.

> "For us, it's about shaping the future not accepting the future."
> PENSION FUND

Impact investment has also been shown to increase member engagement. Therefore, financial benefits to DC schemes can be accrued through increased member contributions, as a result of impact investment, creating a virtuous cycle. One fund we spoke to uses increasingly innovative ways to capture the imagination of their members. For example, they are planning to live stream hatching chicks from reintroduced species, such as golden eagles, at forestry sites they invest in.

LGPS funds are also influenced by the government's levelling-up agenda to impact invest in their local area, to benefit their members and other local stakeholders.

It is worth noting well-funded schemes can often pursue impact opportunities with a more flexible risk and return profile.

Fig 1 | My pension fund invests in impact

The size of each circle represents the number of times the reason was mentioned.

Insight: Of the pension schemes that are intentionally investing for impact, many have taken the view that impact investing has material financial benefits, not just for a specific investment but also to their whole portfolio, through the reduction of systemic risk. For DC schemes, there is the added benefit of improved member engagement while, for LGPS, the levelling up agenda has sparked interest in place-based impact investing.

PENSIONS FOR PURPOSE'S PERSPECTIVE

Pension funds need to be clear why they are allocating to impact investment so that future investment committees understand the role it has in the portfolio. This will avoid confusion and potentially ill-informed decisions at strategy review time.

2. Which impact themes do they target?

Most of the funds we spoke to are not targeting specific impact themes, instead just assessing what comes across their desks. The impacts they do target are often solving issues which are financially material to them – ie the systemic issues that will most likely be detrimental to their portfolio. The most obvious is climate change, which was mentioned by most funds, but others also mentioned issues such as biodiversity loss and socio-economic inequality.

> "We look at impact on a materiality basis and what issues a long term investor may be exposed to."
>
> PENSION FUND

Outside of financial materiality, DC schemes are looking to their members for the impacts most salient to them. For LGPS, these include affordable housing and job creation, which are also important to wider stakeholders. But, again, climate change and biodiversity loss are issues that a lot of people care about.

It was mentioned that in order to decide where a fund can have the most impact, schemes should research themes, not just target what everybody else is talking about.

> "Do research on how important, intractable and neglected different areas are and then, based on that, determine where you would have the most impact."
>
> INVESTMENT CONSULTANT

Insight: Most pension funds are not looking to target specific impacts. Typically, they allocate to impact investments on a case-by-case basis. Despite this, the financial materiality of any ESG factor is the main consideration which comes into play. In the case of the LGPS, issues that matter to local stakeholders are also considered. It was noted that impact data can be difficult to obtain from private equity managers.

When invested, it can often be difficult to get impact data from private equity managers, so pension funds need to convey their reporting requirements before investing in an impact private equity fund.

PENSIONS FOR PURPOSE'S PERSPECTIVE

We encourage pension committees to spend time discussing their investment beliefs and identifying priorities that are underpinned by a clear investment thesis. This leads them to choose impact themes backed up by research, rather than jumping on a bandwagon, such as climate impact, simply because everyone else is. It leads to greater clarity in investment strategies because pension committees have meaningful discussions on how to best align their investment beliefs. Schemes should also clarify their reporting expectations of private equity fund managers before investing.

3. Do they have separate allocations to impact investments?

Although 58% of the funds asked do not have a specific allocation to impact investments, this does not necessarily mean they do not hold impact investments. Some of the funds we spoke to have many impact investments but use existing allocations to incorporate them. The bar chart in Figure 3, shows the impact allocations of the pension funds that have them.

Fig 2 | Do pension funds have separate allocations to impact investments?

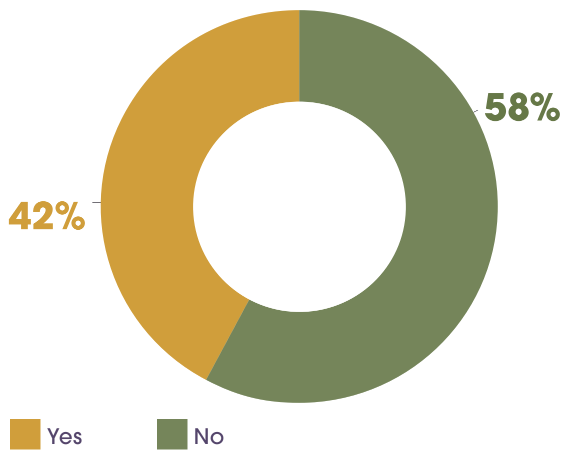


Fig 3 | Pension funds' impact allocations

Insight: 42% of the funds asked have a separate allocation to impact. However, this is not necessarily the best method to achieve impact. In fact, some funds that have higher weightings to impact investment do not have impact allocations.

PENSIONS FOR PURPOSE'S PERSPECTIVE

Trustees should discuss the best approach to incorporate impact within their fund before allocating. This may be through a separate allocation or it may be impact investing within existing allocations. Having clear terms of reference for an impact investment manager, which assesses organisational stability, financial performance and the potential to deliver impact, will lead to more objective decision-making if a review becomes necessary.

4. What are their ESG engagement priorities?

If impact themes are chosen based on financial materiality then, arguably, stewardship activities are even more important. Systemic risk is best kept at bay by engaging with investments and leveraging part-ownership to reduce existing negative impacts.

Climate change is the main driver of engagement, but we are also seeing growth in nature and biodiversity-related engagement, with a few pension funds speaking of their ambitions to achieve deforestation-free portfolios. Labour practices were also highlighted by several funds, with one seeing poor employment standards as symptomatic of a poorly performing company.

> "If things go wrong in this area (employment standards), it is normally indicative of a failing company."
>
> PENSION FUND

Insight: Climate is the main engagement priority for pension funds but there are growing concerns around biodiversity, with some funds mentioning their aim of deforestation-free portfolios. On the social side, employment standards are a key area for engagement.

PENSIONS FOR PURPOSE'S PERSPECTIVE

It is no surprise climate change remains a key engagement priority. Through engagement, pension funds can contribute to meaningful change in the transition to a sustainable, low-carbon economy. Previous *Pensions for Purpose* Impact Lens research into biodiversity, conducted in Q1 2023, concluded pension funds saw biodiversity and climate as inextricably linked. Much of this is being driven by changing regulations, as well as press coverage. Through the pandemic, for example, we saw health and well-being emerge as a priority for pension funds. With the ongoing cost of living crisis, affordable housing and labour practices have also begun to feature in discussions. These themes were all reflected in our interviews.

5. What are the biggest ESG risks and opportunities?

On the environmental side, most pension funds see climate as the number one ESG consideration, either because reporting is a regulatory requirement or they see that fast approaching.

Wind farms are regarded as an opportunity because they benefit from high energy prices and government subsidies. Biodiversity is an emerging risk, with some funds beginning to take notice. Carbon credits are seen as developing options but they also present a risk, comprising nascent and often unregulated markets. One fund also highlighted geopolitical instability and the energy crisis as a major environmental risk.

> “The erosion of geopolitical stability around the world is a really big risk because we need coherent global leadership to get everybody to net-zero.”
>
> PENSION FUND

On the social side, affordable housing was mentioned as an opportunity. However, schemes are opened up to a wider set of opportunities by expanding their investment universe beyond the UK, for example in healthcare, education or microfinance. Risks were identified in diversity, equity and inclusion (a key theme in the US), as well as modern slavery, resulting in reputational risks and rising inequality, leading to systemic risk.

The threat of climate change increasing inequality means that the just transition is an essential lens for an investor to look through. One fund mentioned that growing inequality is going to ultimately result in serious problems – for example, constrained consumer spending, lower productivity and decreased political stability.

> “The gap between the haves and have-nots is going to feel more and more awkward. The more and more interconnected we are, the better off we all should be.”
>
> PENSION FUND

On the governance side, risks are trickier to pin down because, as one fund pointed out, it is often only in hindsight that governance issues can be spotted. Having said that, one fund identified a governance opportunity in private equity investment.

Insight: Climate is seen as the number one consideration, with the carbon market perceived by one fund as both the biggest risk and the biggest opportunity. The development of carbon and biodiversity credits will also help to price externalities more accurately, which would be positive for continued growth in the ESG and impact movement. Other opportunities existing within climate were mentioned, such as renewable energy, which has pertinence given high energy prices. The social side also provides many opportunities, particularly when looking through a global lens. Rising inequality is a key systemic risk facing the world though, and investors should address this by applying a just transition lens to their ESG activities. Within the ‘G’, private equity also provides an opportunity, for impact and for risk and return, because larger stakes allow for greater influence over the investee company.

"In private equity, you have a more meaningful ability to exercise governance because you, or your investment managers, generally have larger stakes and can influence events more. So that's clearly an opportunity."

PENSION FUND

PENSIONS FOR PURPOSE'S PERSPECTIVE

The carbon credits market is predicted to grow from $2 billion today to $1 trillion in 15 years[1]. However, it faces challenges over integrity and credibility that need to be addressed before it becomes a consideration for the majority of pension funds.

Columbia Threadneedle Investments' views – on the biggest ESG risks and opportunities

As a strong supporter of the UN Sustainable Development Goals (SDGs), we believe in leveraging our position to influence, drive positive impact and promote long-term sustainability. We believe that the appropriate management of ESG risks and opportunities not only reduces risk but also enhances shareholder value.

The biggest risks we identify in our portfolio companies are cybersecurity, health & safety and climate change. These are risks that face all businesses and need to be actively managed to ensure business continuity. *Columbia Threadneedle Investments Private Equity* has invested in companies providing solutions in each of these areas: helping to prevent cyberattacks to critical infrastructure and hospitals; removing people from hazardous environments through the use of technology; and reducing carbon emissions and helping adaptation to the changing environment.

As well as investing in companies tackling ESG risks, enhancing ESG practices can add significant shareholder value. Companies with high ESG standards and well-defined purpose are better able to recruit and retain talent (otherwise a key limitation to growth), benefit from growing desire to buy sustainable products and command a premium from investors.

6. Are they measuring the net-zero alignment of their portfolios?

Given climate is the principal impact and ESG consideration for pension funds, we assessed how many of our interviewees are measuring the net-zero alignment of their portfolio, see Figure 4.

Fig 4 | Are pension funds measuring the net-zero alignment of their portfolios?

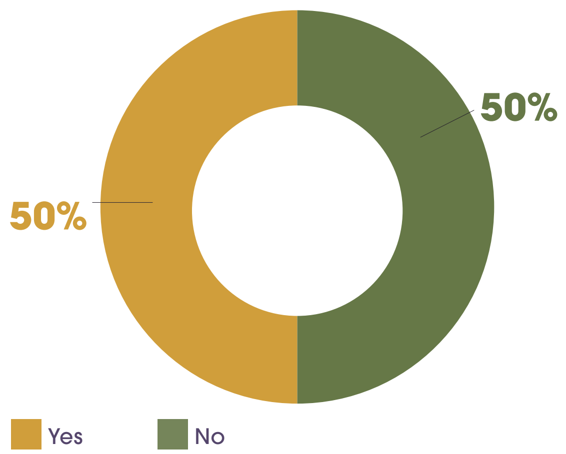
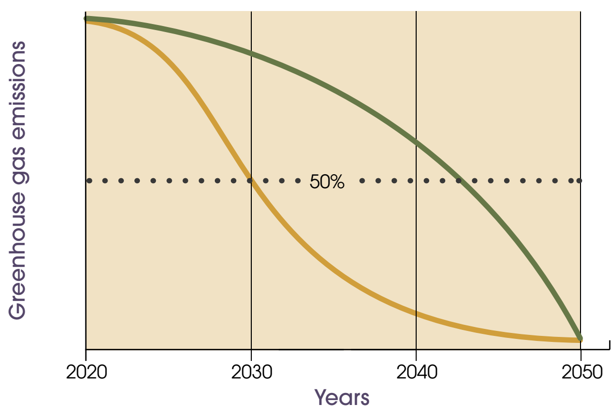


Fig 5 | The transition pathway necessary for 1.5 degree warming



Although this research mainly focused on LGPS schemes (not yet required to report under TCFD regulations), many of them have already begun to report their net-zero alignment annually. Although 50% are measuring it, they are unable to get net-zero alignment data for large portions of their portfolio, usually due to issues with getting data from their private markets' investments.

Insight: Fifty per cent of pension funds are currently reporting the net-zero alignment of their portfolio. Data quality and coverage is an issue, however.

PENSIONS FOR PURPOSE'S PERSPECTIVE

Pension funds should continue to engage with their asset managers to provide better quality data coverage. This is an equally important target alongside improving the net-zero alignment of their portfolio. When making new investments, schemes should be upfront with their net-zero alignment reporting expectations.

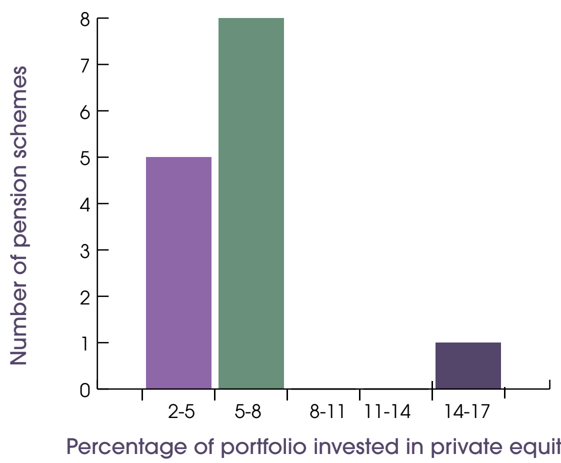
2 How do pension funds view private equity?

How do pension funds view private equity?

1. What are their allocations to private equity?

Many pensions funds are in the process of de-risking and as a result their allocations to private equity are staying the same or decreasing. For DC, with private equity often being the more expensive of the private market asset classes, it is more difficult to incorporate. However, with private equity being an attractive prospect for both impact and returns, appetite to invest is still strong.

Fig 6 | Allocation to private equity funds



Insight: Allocations to private equity are in the single figures, for the vast majority. Many schemes are de-risking, so, for them, increases to their allocations are unlikely. But, due to the attractiveness of the asset class financially and for impact, demand is there.

PENSIONS FOR PURPOSE'S PERSPECTIVE

Pension funds should assess their ability to invest in private markets holistically, considering financial and impact considerations. For example, a well-funded scheme may take the view that increasing their exposure to private markets is worthwhile for the increased impact they could have.

2. How interested are they in co-investments or secondaries?

Co-investments are seen as laborious, requiring greater due diligence and, as a result, most funds are unable to invest directly in them. This is particularly true for smaller LGPS funds that do not have sufficient resources.

However, many schemes are keen to access co-investments due to their lower fee levels and they were referenced as an ideal solution by many of the interviewees.

Secondaries were also endorsed for their ability to fit into DC master trusts' fee budgets.

> "We're cognisant of the fact we'll probably have to use some level of secondaries because we don't have sufficient fee budget to not use secondaries to some extent."
>
> PENSION FUND

Secondaries are also seen to have diversification benefits and, while they may make it harder to engage with the fund manager, this was not seen as an issue with impact private equity funds. Because of their focus on impact, ESG engagement was seen as less of a priority.

Insight: In general, co-investments were seen as resource-intensive and, for the smaller LGPS, the governance burden was too heavy for them to consider investing. As a result, co-investing alongside a fund manager was seen as a good solution. For DC schemes, there were considerable upsides to co-investments - lower fees open doors to opportunities otherwise inaccessible because of cost caps imposed upon the pension fund. From a stewardship perspective, investing in secondaries may make it more difficult to engage, but this was not seen as an issue with impact investment funds. It was also noted that secondaries have diversification benefits.

PENSIONS FOR PURPOSE'S PERSPECTIVE

The benefits of co-investing were understood by interviewees but the governance burden remains a major hurdle for all but the largest funds. For the LGPS, a pooled solution providing a mix of primary, secondary and co-investment opportunities, something many pools are considering or offering already, suggests that collaborative structures, which allow pension funds to share the governance burden, can provide smaller funds with access to opportunities such as co-investments.

Columbia Threadneedle Investments' view –
the benefits of a multi-manager co-investment fund

A multi-manager co-investment fund has various benefits compared to investing in a direct fund. These include:

- A relatively concentrated portfolio of circa 15-20 portfolio companies providing greater diversification and therefore lower risk than a typical direct fund.
- There are several management groups, each responsible for leading one or more investments, helping to mitigate single manager risk.
- The portfolio will have notable geographical and sectoral spread.
- Comparatively low 'all in' fee level, versus direct funds.
- The potential for outsized returns from 'home runs' is retained.

A multi-manager co-investment fund managed by an experienced private equity manager has a number of benefits versus a pension fund 'going it alone' and doing co-investments directly. These include:

- Dramatically reduced administrative burden investing in a single multi-manager co-investment fund, like *Castle Mount Impact Partners LP,* when compared to a pension fund making 15 or more separate co-investments.
- Access to deal flow, *Columbia Threadneedle Investments Private Equity* has made in excess of 100 co-investments and has significant co-investment deal flow, typically 100+ potential co-investment opportunities per annum, an opportunity set few pension funds have access to.
- Investment risk mitigated through diversification by lead manager, strategy, geography and sector.
- Reduced risk, but with no reduction in potential return – *Castle Mount Impact Partners LP* is targeting 15%+ net internal rate of return (IRR).

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3. How important are liquidity and time horizons?

Given our interviewees were mainly from LGPS, liquidity was not an issue. They are well-placed to benefit from the illiquidity premium, so instead of it being a barrier to investment in private equity, it simply shapes the size of their allocations.

Having said that, liquidity is still a big issue for many UK pension funds, particularly DB schemes that are close to buyout. Investment consultants were hopeful, however, that liquidity is declining in importance for DC schemes.

> “We can get around daily liquidity, it’s not mechanical but regulatory and cost-based, which can make longer time horizons difficult sometimes.”
>
> PENSION FUND

Charge cap reforms should also help with allocations to private equity.

> “I’m hoping for the finish of the race to the bottom on fees in DC and more of a focus on value, which in turn means the ability to charge more, meaning you can go more illiquid.”
>
> INVESTMENT CONSULTANT

We also asked what time horizons pension funds have for assessing the impact and returns of impact private equity funds – this was around five years after the deployment of their capital.

Insight: Although liquidity may be an issue for DB schemes close to buyout, the LGPS and DC pension funds we spoke to didn’t see lack of liquidity as an issue. The LGPS see themselves as well-placed to benefit from illiquidity premiums and the DC schemes we interviewed have issues elsewhere, namely in fee limitations. Time horizons for assessing returns and impact were around five years after capital deployment.

PENSIONS FOR PURPOSE’S PERSPECTIVE

We encourage DC schemes to work with asset managers to find innovative ways to fit private markets allocations into their portfolios. The characteristics of private equity – both impact and financial – are highly sought after but, as with any investment, there will be a list of advantages and disadvantages, and the investor must weigh these up against each other, according to their own financial and impact goals.

3 How do pension funds view impact in private equity?

How do pension funds view impact in private equity?

1. Why is private equity a well-placed asset class for impact?

Sixty per cent of interviewees said private equity is their preferred asset class for impact, with a further 20% pointing to private markets more generally. One fund referred to the widening of the investment universe in impact private equity over the past few years which has made it more investible.

A few pension funds also mentioned that, when impact investing, they are targeting an earlier stage of private equity (usually growth capital) than with their generalist private equity portfolios, because this allows for higher levels of impact.

Various reasons were outlined as to why private equity is well-placed for impact:

- It provides a vehicle to support breakthrough technology and innovation.
- There is a wider universe of ideas than in public markets.
- The closeness and influence GPs have over portfolio companies allows for greater increases in the scale and depth of impact than in public markets.
- There is a lot of scope for private equity managers to drive change due to their influence.
- There is a good return profile.

Insight: Most pension funds and their advisers see private equity as the best way to achieve impact. Many reasons were outlined for this: they can support innovation; there's a broader universe of ideas; GPs have greater influence over the company than public equity fund managers (due to greater stakes in investee companies); and the return profile is good.

PENSIONS FOR PURPOSE'S PERSPECTIVE

For pension funds that already invest in private equity, introducing purpose can be a relatively straightforward step given the rapidly growing number of suitable investment opportunities in a fast-evolving market. However, funds should carefully consider how they measure and monitor the impact from their investment and what they will expect to see delivered over time.

Columbia Threadneedle Investments' view – why private equity is ideally placed for impact investing

While private equity accounts for a relatively small percentage (circa 16%) of the capital deployed in impact, we believe that it is an ideal medium for impact investing. Private equity's business model and accountability structure enable investors to select managers whose values and investment strategy are aligned with their own and focus on long-term sustainable growth and strong corporate governance. Investors are then able to benefit from very detailed reporting of both financial and impact performance.

Private equity investing is based on extensive due diligence prior to investment, active engagement, and relatively long hold periods of three to seven years. These characteristics all lend themselves well to impact investing. The level of due diligence and engagement is typically many orders of magnitude greater than that available to (or financially viable for) an investor in public equities. Private equity investors usually have access to confidential information, can question management on all parts of the business, and can commission extensive ESG and impact due diligence. This means that, by comparison with public market investors, private equity investors have a much greater ability to assess current and potential future impact (both positive and negative) prior to investment, and to influence and measure that impact post investment. Private equity firms are typically represented on the boards of their portfolio companies, input into all major strategic and operational decisions, and track performance through detailed KPIs. This strong corporate governance model allows private equity investors to monitor progress in all areas of the business including ESG and impact. In many cases the private equity firm will control the board and company, often holding a majority stake in the business, so any manager that underperforms (including on ESG or impact criteria) can be replaced – an option not available to investors in most other asset classes.

The long-term nature of private equity investment is also well suited to impact investing. Private equity investors can focus on the long-term sustainable success of their portfolio rather than focusing on quarterly results or short-term share price fluctuations. This enables private equity investors to focus on strengthening any weaknesses identified in due diligence, investing in leading ESG and impact practices, and laying the foundations for sustainable growth.

Finally, private equity investors can access a much larger pool of innovative and potentially disruptive companies which are developing new solutions to address key global challenges. Often these companies have a single business model, making it much easier to assess and maximise impact versus larger listed companies that often have multiple business units with varying positive and negative impacts.

2. How important is 'additionality'?

One investment consultant said the lack of pension fund understanding around additionality is because the impact investing industry is still unclear on what it means. Based on a strict definition of additionality – ie the allocation of new capital to a company or project that would not otherwise have received that funding – most of the pension funds we spoke to are 'additionality agnostic'. It is also important to note that evidencing additionality is particularly difficult; one consultant said, as a result, they typically accept weak evidence of it.

> "I don't think clients understand additionality as much as we'd want them to. How you create additionality only starts to come through as we're looking at different products and then we explain it to them. Their primary consideration, at the end of the day, is whether their investment is having some measurable impact."
>
> INVESTMENT CONSULTANT

Although additionality is less clear through secondaries, pension funds' approach to the subject means that impact private equity opportunities in secondaries are not ruled out.

Despite most of the pension funds we spoke to being agnostic about additionality, there were two situations that were seen as an exception. The first is when looking for opportunities that are underserved by the market and could be a driver of returns. The second is where LGPS believe they can stimulate place-based impact through their investments. One pension fund we spoke to has acted as a major catalyst for local economic growth by encouraging neighbouring LGPS to invest alongside them, thereby attracting asset managers to invest in their region.

> "If we can be a first close investor in funds, it does attract other LGPS. We can be a catalyst for those funds and so effectively attract more capital into our region. That's happened several times."
>
> PENSION FUND

Insight: The investment consultants we spoke to pointed to a lack of client understanding of additionality. There is also the question of how investors can evidence additionality. Consequently, most pension funds don't seek additionality, but clear and measurable impact. In our sample, the exception is one of the larger LGPS that has place-based impact goals and is acting as a catalyst for local economic growth by engaging asset managers to set up funds which invest in their local area, thereby encouraging neighbouring LGPS to invest. It was also mentioned that additionality could be a driver of returns by identifying opportunities underserved by the market.

PENSIONS FOR PURPOSE'S PERSPECTIVE

While purists may argue that additionality is necessary for authentic impact investing, we take a more pragmatic view. In today's market, it can be difficult to scale impact investments in private markets to suit a very large pension fund. For a scheme starting its impact journey, there are also benefits in allowing trustees to become comfortable with impact in listed equities first, before seeking to achieve impact in the private markets. We consider there is a role for listed and unlisted impact investments in a pension fund portfolio.

3. What percentage of them are invested in impact private equity?

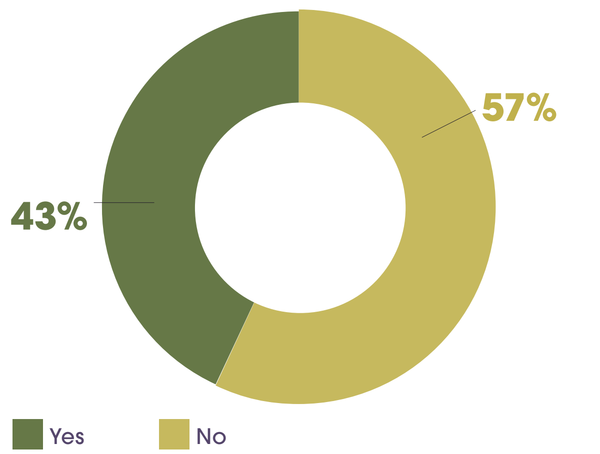
One interviewee's perception that impact investing in private equity is a somewhat niche strategy, made them feel their scheme would be opened up to higher risk. As a result, they decided not invest in any impact private equity funds.

Insight: 43% of the funds interviewed are invested in impact private equity.

PENSIONS FOR PURPOSE'S PERSPECTIVE

There is work to be done in soothing trustees' fiduciary duty anxieties when it comes to impact investing.

Fig 7 | Pension funds invested in impact private equity



4. Are they looking at single-focus or diversified products?

Some pension funds are looking to niche, single-focus products that they can approach from a bottom-up perspective and use to diversify their own portfolio. With funds that have smaller private equity allocations, diversified products are seen as a useful tool to access impact opportunities across a wider range of sectors and geographies.

Insight: Some pension funds are keen to focus on single strategy products and move away from diversified products but others see the benefits of diversified strategies, particularly if their private equity allocation is small.

PENSIONS FOR PURPOSE'S PERSPECTIVE

In wider conversation with our members, we have observed three primary ways that funds allocate to impact investments:

- A minimum or target percentage allocation to a range of different impact solutions.
- A targeted allocation aligned to specific beliefs.
- A finance-first broad set of ESG themes that are not specifically impact-focused but which may include impact investments.

Our insights from this research support the broader conversation we had with our members.

5. What are their geographical preferences for impact?

In recent years, the geographical focus of UK pension fund impact has been quite broad, with most funds opting for global impact strategies. After all, as one investment consultant mentioned, that is where we have seen the best managers with the best ideas. For many DB and DC schemes it is still global, with some DC master trusts pushing towards more domestic impact to help drive member engagement. The trend within LGPS is very much moving towards local impact, given the government's levelling up agenda. However, local means different things to different schemes. Some see local as within the UK whereas others prefer to invest in their region or local authority confines to appeal to members and local stakeholders. It is worth noting there are potential political challenges for LGPS in investing within their local authority area.

Another shift has been away from emerging markets, as pension funds de-risk over time. This is problematic in that we need capital to flow to solutions globally to help every country transition to net-zero, for example. Consequently, allocating capital globally, in this way, is impactful. At the moment, however, most pension funds are not looking through this lens.

"For clients that are really focused on the just transition and impact, they are led back to emerging markets exposures and the role they need to play. That's where there's so much opportunity to maximise your impact. But the average client is not thinking that clearly."

INVESTMENT CONSULTANT

PENSIONS FOR PURPOSE'S PERSPECTIVE

Pension funds should be aware that there is potential for impact in emerging markets. It is also worth noting that the opportunity set may be limited by focusing exclusively on UK impact.

One pension fund mentioned that some large emerging economies such as China and India do not have net-zero by 2050 targets. Therefore, when investing, it is important to investigate the ESG credentials of the company and whether that fits with your ambitions.

We observed that pension funds are mainly focusing their social impact efforts on place, whether that is regional or across the whole of the UK. Their efforts in climate impact tend to be more global, given the all-encompassing nature of climate change.

Insight: Traditionally, the geographies of pension fund impact have been global but the trend for UK pension funds is to have a more domestic focus. This is largely driven by the LGPS and the government's levelling up agenda, but also from DC funds who see UK impact as having high potential for member engagement. Impact ambitions tend to vary across impact themes. The focus of social impact is mainly within the UK, whereas climate impact tends to be more globally oriented.

Fig 8 | Leveraging in-house private equity and responsible investment capabilities

1. Mid-market private equity specialist

- 30+ years of mid-market PE experience
- 130+ years of combined PE experience
- >100 leading GP relationships
- c. €3.0bn invested since early 1980s, and strong returns demonstrated across economic cycles

2. Proven co-investment programme

- >€750mn invested in co-investments since 2003
- Strong pipeline with c.100 deals reviewed per year
- 45 realised co-investment, returning 2.4x cost and 23% IRR
- **3.2x cost and 31% IRR on realised qualifying investments**

Castle Mount Impact Partners LP
Impact Co-investment Fund
('the Fund')

4. Award winning in-house RI capability

- UNPRI founder signatory, with 35+ years of RI experience
- First ethical fund in the UK, launched in 1984
- 40+ person team, with c. 400+ years of experience
- €1 trillion[1] of assets under engagement through reo®

3. Strong private equity impact/ESG leadership

- 10+ years of impact ESG/leadership
- Pioneering 2011 vintage climate change fund
- Experience from 2013 vintage clean energy fund
- Active engagement on ESG within industry

[1]As at 30 June 2022. (Includes external reo® clients only).

 Source: ©Columbia Threadneedle Investments.

Columbia Threadneedle Investments' approach to impact private equity

Columbia Threadneedle Private Equity is currently raising *Castle Mount Impact Partners LP* ('*CMIP*' or 'the fund'), an impact fund that is targeting 15-20 investments in high growth, purpose-led companies whose products or services address fundamental human and planetary needs and where financial returns and positive impact are aligned. The fund will invest in three core themes – environmental sustainability, health & well-being, and equality & inclusion – where we have a strong pipeline and track record (realised returns of 3.2x cost and 31%, as at 31 December 2022).

CMIP is targeting buyout and growth investments in the lower mid-market, a large and less competitive market that favours sector and regional specialists, and where we have an excellent network of proven investment partners. *Columbia Threadneedle Investments* will use its in-house impact expertise and work with company management to measure and maximise impact, ensuring best practice impact investing procedures are applied whether investing alongside an impact specialist or mainstream private equity firm.

This exposure to potential impact deals done by mainstream private equity firms is a key advantage of the fund, as many of the best potential impact investments may be done by mainstream investors given the attractive characteristics of the companies being targeted. However, there is a risk that the potential impact of these companies will not be maximised without the engagement of *Columbia Threadneedle Investments*, including the development of clear impact targets and their measurement. By sourcing deals from both specialist impact investors and leading mainstream private equity firms *CMIP* will benefit from excellent deal flow, from which it can select the very best investments from an impact and financial returns perspective. By investing with mainstream GPs, the fund will also aim to accelerate the adoption of impact measurement and the growth of the impact investment sector.

Please note Pensions for Purpose collaborate on research projects with our members, we do not endorse any underlying funds. See page 37 for our full disclaimer.

6. What are their crucial criteria for impact private equity funds?

Of the funds we asked this question, 67% said they look at impact characteristics before financials. It was mentioned that investment consultants tend to do this the other way around. For a few of these funds, their impact ambitions directly inform their investment universe. When assessing the impact of a fund, schemes assess the impact narrative and whether it is verifiable. One investment consultant also pointed to the need to be able to quantify the fund's impact.

> “If somebody came up with a way of making nuclear fusion actionable within the next three years, that would be a very big impact. If somebody set up a company and one homeless person may end up not being homeless anymore as a result, that would be a smaller impact. What you want to do is take all the impact investing opportunities and quantify how much impact they're making. I appreciate this is difficult but it really matters.”
>
> INVESTMENT CONSULTANT

This point speaks to the lack of standardisation within the industry. Having said that, we don't always need to be able to compare like for like. If pension funds do their research, with the help of their consultants, they can learn more about where they are able to make the greatest impact. When decisions have been made on where to invest, schemes should set out reporting expectations of their managers so they can assess what their outputs and outcomes are.

Risk-adjusted return is the main consideration, with private equity having a high return profile and most pension funds being unable to sacrifice on returns. Another important area is track record, although it was noted that a balance must be struck between supporting new and innovative ideas, which are particularly prevalent in the impact space, and assessing prior performance.

One LGPS fund mentioned that investment manager remuneration is an important consideration. Their preference is to ensure the manager is incentivised to perform well via carried interest, albeit this must be balanced to ensure managers do not receive performance benefits for average performance. This is more of an issue for DC schemes, of course.

> “Fees are unfortunately the elephant in the room.”
>
> PENSION FUND

Insight: Track record and risk-adjusted return profile are central when assessing impact private equity funds. However, it was noted that there can be tension between prior performance and emerging strategies, particularly in the impact space, so a balance must be struck. The impact narrative was assessed before financial and practical considerations by 67% of those asked and should be considered comparatively, to assess where a pension fund can have the greatest impact. For DC schemes, fee levels often make impact private equity funds difficult to invest in, albeit the schemes we spoke to are trying to work around this.

PENSIONS FOR PURPOSE'S PERSPECTIVE

When considering impact investments, pension funds need to agree the weight given to financial versus non-financial (impact) criteria before embarking on a procurement exercise. We would like to see investment consultants placing an equal weighting on the two: at present, more weighting is put on the financial criteria with some consultants paying minimal attention to the impact being delivered. We also encourage funds to extend their investment, operational and legal due diligence processes to include impact due diligence, prior to investing. Impact assessments should be conducted comparatively, to assess where schemes can have the most impact.

4 How do pension funds view impact private equity returns?

How do pension funds view impact private equity returns?

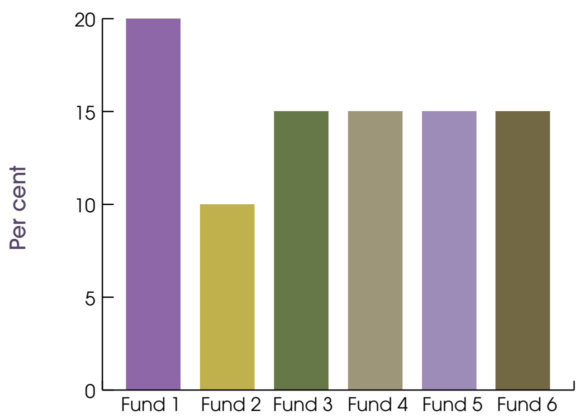
1. What are their return expectations from private equity?

One of our interviewees was more than 100% funded and so took the view that returns from private equity were less important. They were willing to take on lower than expected return investments that had significant impact characteristics, as long as the fund's investments were aligned with their overall return goals.

> "Our investments are assessed on the expectation that we are aiming for 10% return broadly across asset classes. If the combination gives us that target level, then we can look at some investments that have stronger impact but lower return as part of the whole package."
>
> PENSION FUND

Insight: The mean return expectation from private equity from the schemes questioned was 15%.

Fig 9 | What returns do pension funds expect from private equity?



PENSIONS FOR PURPOSE'S PERSPECTIVE

Schemes will likely have high return expectations for private equity, given the characteristics of the asset class. However, in cases where a scheme is very well-funded, there should be a recognition that opportunities to pursue more impactful investments can be incorporated, as long as the overall return expectation of the fund is met.

2. What does the academic literature on impact versus generalist fund returns show?

All the pension funds asked had no data on the returns of their impact investments versus their generalist portfolios. Therefore, we looked to academic research to answer this question. The academic literature on the returns of impact versus generalist portfolios is limited. However, there have been a few studies from which we can gain insight.

One of the studies we reviewed found that investing in impact funds achieves lower returns[2]. Although, another study found that impact funds have similar risk-adjusted returns because impact funds pose less risk[3]. It is difficult to take these findings at face value, however, given that they had differing sample sizes of impact versus generalist portfolios. In fact, one study used 50 times more generalist funds than impact funds to find their average[2]. This is because impact funds only occupy a niche section of the market, so data is more difficult to get hold of.

However, there is also academic research which finds that portfolios with impact investments often achieve higher returns than those that do not.[4] This is supplemented by the findings of other academic studies that market-rate return seeking impact funds can achieve results comparable to the market indices[5]. This proves that there are impact strategies out there that can achieve similar or better returns than the market.

Insight: Academic research on the returns of impact funds versus generalist funds is limited and more work needs to be done. Methodological limitations and the infancy of the industry hinder the reliability of present research findings. Therefore, it is difficult to definitively answer whether impact funds produce higher returns than generalist funds. However, the research shows that there are opportunities for alpha in impact investing.

PENSIONS FOR PURPOSE'S PERSPECTIVE

Impact private equity funds provide great opportunities to match or beat the market. As with any fund selection exercise, the skill is in finding the best opportunities. Our Q3 research will be on impact fund performance, where we hope to surmount the methodological limitations of previous studies, by focusing solely on market-rate return strategies and comparing the averages of different asset classes to appropriate benchmarks.

Conclusion

Conclusion

This research has uncovered unique insights into the views of UK pension funds on impact private equity. We discovered that the biggest reason they impact invest is to shape a better future, which will, in turn, reflect positively on their portfolios. Unsurprisingly, climate was shown to be the most prevalent ESG theme in the minds of our interviewees, both from a risk and an opportunity perspective.

Private equity was seen as the most effective lever for impact by 60% of those asked. Despite this, additionality, a key feature of impact private equity, was generally seen as a less important impact characteristic. The focus of UK pension fund impact was seen to be shifting towards place-based investment, given the government's levelling up agenda for the LGPS, while appetite for global impact was more climate-oriented. Of the funds questioned, 67% looked at the impact characteristics of an impact private equity fund before the financials, however market-rate returns were still expected. It was, therefore, encouraging to read in the academic literature that there are opportunities for alpha in impact private equity.

Columbia Threadneedle Investments' view on the research

It is very encouraging to see that UK pension funds recognise the excellent financial returns and positive impact available through private equity impact investing. While philanthropy and concessionary impact investing play an important role, we believe that there is no need to make a compromise on financial returns to have a positive impact. This is critical, as it allows investors to meet their fiduciary responsibilities and grow their assets while addressing urgent global challenges, and it is only through the mobilisation of investors' capital that these urgent challenges can be overcome.

Individuals are increasingly keen to align their investments with their values. By investing for positive impact, we believe that pension funds can both drive engagement with their members and help to de-risk their retirement both financially and through helping to tackle global challenges including population growth, resource scarcity, climate change, biodiversity loss, terrorism, and new and re-emerging diseases.

In addition to climate change, we would encourage pension funds to actively combat other risks facing the world and their members directly such as the spiraling cost of healthcare due to increasing life expectancy, aging populations, and increasing levels of obesity. In the wake of the Covid-19 pandemic healthcare is evolving and changing as never before. Those companies able to provide more effective and more efficient solutions, driving better patient outcomes and cost-effective solutions for healthcare payers offer significant impact and financial returns.

The views on additionality are interesting. We look at additionality at both the portfolio company and investor level. At the portfolio company level additionality is key to our assessment of impact, comparing the company's product or service versus alternatives and competitors (for example, a novel treatment of a previously untreatable disease would have more additionality than one for a well-treated disease). At the investor level additionality is more difficult to evidence when investing for market rate returns. However, we see our engagement with portfolio companies on ESG and impact, helping them to measure and articulate the positive changes they are making to stakeholders, as a differentiator and element of additionality versus investment by a non-impact focused investor. Similarly, UK pension funds can drive additionality through investment with smaller, local impact managers with proven track records and impact investing methodologies driving growth of the impact ecosystem, rather than channelling investment to an ever-smaller number of large non UK-based private equity funds for whom impact is non-core.

Appendix

Appendix 1 | Interviewees who gave permission for their name to be listed in our report

Pension funds/pools	Investment consultants
Brunel Pension Partnership	bfinance
Clwyd Pension Fund	Hymans Robertson
Cushon	ISIO
East Riding Pension Fund	Mercer
East Sussex Pension Fund	Redington
Greater Manchester Pension Fund	
Kent Pension Fund	
LGPS Central	
Local Pensions Partnership Investments	
London Pensions Fund Authority	
Merseyside Pension Fund	
North Yorkshire Pension Fund	
Smart Pension	
Strathclyde Pension Fund	
Surrey Pension Fund	
Tyne and Wear Pension Fund	
Wiltshire Pension Fund	

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